Modification proposal:	**Uniform Network Code (UNC) 404: Profiling of LDZ capacity transportation charges for Small Shipper Organisations (UNC404)**		
Decision:	The Authority[1] has decided to accept this proposal[2]		
Target audience:	The Joint Office, Parties to the UNC and other interested parties		
Date of publication:	12 July 2012	Implementation date:	To be confirmed by the Joint Office

Background to the modification proposal

From 1 October 2008 distribution transportation revenues have been recovered on the basis of 95% capacity and 5% commodity charges. This followed the earlier decision of the Authority not to veto the proposed move away from the previous 50:50 split, as set out in the Distribution Network Price Control report 03 (DNPC03).

The change in the split of revenue recovery through system charges was based on analysis which showed that very little of the Gas Distribution Networks' (GDNs') costs were driven by gas throughput (commodity). The analysis identified that shrinkage and odorant were the only costs related to throughput and contributed between 4 and 6 per cent of total GDN costs. It was also considered that reducing the proportion of commodity based charges would increase the predictability of the amounts charged to shippers for transportation and therefore facilitate competition among shippers and suppliers[3].

The modification proposal

In May 2011 Utilita proposed UNC383 which sought to allow shippers, subject to certain conditions, to profile their Local Distribution Zone (LDZ) transportation charges such that a greater proportion is paid in the winter months. They considered that this would address a mismatch between shippers' costs and revenues, the latter of which can be expected to be higher in the winter months. Utilita argued that the effect of DNPC03, redistributing costs more evenly throughout the year, had the potential to cause cash flow issues during the summer months, creating a potential barrier to entry.

Scotia Gas Networks (SGN) raised UNC404 in response to UNC383. UNC404 also proposes that certain shippers who meet the prescribed criteria will be offered the option of flexible payment arrangements, deferring up to 50% of the transportation charges that would be levied over the summer months when revenues may be at their lowest. However the deferred amounts must be repaid over subsequent months (including any relevant interest and administration charges) such that they are paid in full by the end of the relevant financial year.

Whereas UNC383 sought only to limit this facility to shippers with fewer than 500,000 supply points, in order for a shipper to qualify for these flexible payment terms under UNC404 they must meet all of the following criteria:

a) they must hold less than 100,000 *Smaller Supply Points* across all Distribution Networks (DNs);
b) they must have a *Code Credit Limit* of less that £500,000 recorded with the particular DN whose payments they wish to profile, and;

[1] The terms 'the Authority', 'Ofgem' and 'we' are used interchangeably in this document. Ofgem is the Office of Gas and Electricity Markets.
[2] This document is notice of the reasons for this decision as required by section 38A of the Gas Act 1986.
[3] Subsequently, in January 2011 we vetoed DNPC07 which proposed to change the split between capacity and commodity charges from 95:5 to 100:0 respectively.

c) the shippers maximum *Value at Risk (VAR)* in the three months prior to May of the relevant year must be less than their *Code Credit Limit*.

The proposal is clear that the obligations set out in Section V of the UNC relating to *Code Credit Limits* would not be altered by this proposal, nor would the sanctions that may be applied if the shipper failed to adhere to the repayment timescales or the UNC Credit Rules more generally.

UNC Panel[4] recommendation

At the UNC Panel meeting held on 19 April 2012 one vote was cast in favour of implementing UNC404 and eight against. The UNC Modification Panel therefore did not recommend implementation of the proposal.

The Authority's decision

The Authority has considered the issues raised by the modification proposal and the Final Modification Report (FMR) dated 07 June 2012. The Authority has considered and taken into account the responses to the Joint Office's consultation on the modification proposal which are attached to the FMR[5]. The Authority has concluded that:

1. implementation of the modification proposal will better facilitate the achievement of the relevant objectives of the UNC[6]; and
2. directing that the modification be made is consistent with the Authority's principal objective and statutory duties[7].

Reasons for Authority decision

We note that the proposer, respondents and the UNC panel focused on the potential impacts of UNC404 upon effective competition. There were also some comments regarding the proposals effect upon the efficient administration of the UNC. We agree that these are the appropriate objectives against which to assess this proposal and have therefore assessed the proposals against relevant objectives d) and f). We consider that the proposals would have a neutral affect on the other relevant objectives.

Objective d) – the securing of effective competition between [relevant shippers]

The majority of respondents considered that this proposal would have an impact upon effective competition, though views were mixed on whether this would be a positive or a negative impact. The greater number highlighted that as the proposal was specifically aimed at smaller shippers, it would have a discriminatory effect. We note that this was acknowledged by the proposer and, notwithstanding the merits of this particular proposal, welcome that efforts are being made to address the concerns of smaller participants and new entrants in particular.

We consider that credit rules by their nature must differentiate between different parties based on their credit standing and the extent of risk they impose upon counter-parties, in

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[4] The UNC Panel is established and constituted from time to time pursuant to and in accordance with the UNC Modification Rules.
[5] UNC modification proposals, modification reports and representations can be viewed on the Joint Office of Gas Transporters website at www.gasgovernance.com
[6] As set out in Standard Special Condition A11(1) of the Gas Transporters Licence, see: http://epr.ofgem.gov.uk/EPRFiles/Gas%20Transporter%20Standard%20Licence%20Conditions%20-%2010-11-2011%20-%20Current%20Version.pdf
[7] The Authority's statutory duties are wider than matters which the Panel must take into consideration and are detailed mainly in the Gas Act 1986.

this case the GDNs. The crux of UNC404 is therefore whether there is a relevant difference between shippers, based on the proposed criteria, which may justify differing treatment by the GDN.

The UNC credit rules already contain an element of discretion. For instance, UNC Section S 3.5.5 states that where a payment becomes overdue, the Transporter *shall be entitled* to reject new capacity bookings or supply point nominations, not that they *must.* We consider it unlikely that a GDN would immediately resort to the sanctions allowed for under Section S in the event of a relatively small late payment, especially when they are in communication with the shipper and the situation is being responsibly managed. We further consider that such flexibility is no more than could reasonably be expected in any other commercial arrangement. It may therefore be the case that UNC404 is not creating this flexibility, but merely managing the shippers' expectations and ensuring that there is a greater degree of consistency across all GDNs.

However, we also recognise that there must be limitations to the flexibility and that it could, if uncapped, redistribute a cash flow problem from the shipper(s) to the GDN(s). We therefore consider it is appropriate that this is capped in some relevant way. Whilst the figure of 100,000 small supply points may be a largely arbitrary threshold, it is not dissimilar to those that have been used elsewhere[8]. We would have welcomed some further assessment of whether this is an appropriate figure, but we also note that there were no strong arguments in favour of any other figure.

Notwithstanding this, we consider that the monetary threshold of VAR is a legitimate limiting factor. Again, there appears to be very little evidence as to why £500,000 VAR is an appropriate threshold, but information provided by the GDNs shows that several established shippers would fall beneath this threshold and would therefore have opportunity to benefit from this flexibility. Conversely, we consider that a higher or unlimited cap may have the effect of redistributing the cash flow risk to GDNs to such an extent that it would impose additional financing costs upon them, or in the extreme could place them at risk of default on their own liabilities.

We also consider that this proposal may be too restrictive in specifying the months in which a shipper can take advantage of this option. Whilst we recognise that it was originally raised in order to address the specific concern about revenues potentially being lower in the summer, there may be shippers who experience tightened cash flows at other times of the year, for whatever reason. This may therefore limit the value of this proposal to those shippers who receive the majority of their revenue in the form of cash or variable direct debit, rather than fixed direct debit as is the norm.

We note the concern of some respondents that this may artificially limit a shipper's growth, as they may not want to exceed the 100,000 threshold of small supply points. We consider that this is highly unlikely to restrict shippers' growth ambitions, not least as there are far greater advantages to be gained from attracting new customers that will more than offset losing this flexible payment option. Further, we would expect that a review of the appropriateness of this threshold would, if still required, be prompted by any shipper approaching it if not before.

Several respondents noted that the GDNs should not become a lender of last resort. Whilst we would fully support this principle, as mentioned above we consider that this proposal does little more than codify the discretion that we would ordinarily expect GDNs, or indeed any other company to demonstrate. Furthermore, we note that the UNC already envisages the potential for late payments and nothing in this proposal would

[8] For instance, the Carbon Emissions Reductions Target will only apply to suppliers with more than 250,000 customers.

obviate the shippers(s) liability for associated interest payments, as already set out in Section S. We therefore do not consider that this will in effect require the GDNs to act as lenders of last resort, but do recognise that several shippers may gain benefit from this proposal that is proportionately far greater than the relatively small increase in risk to the GDN. Whilst any deferred payments may have the effect of increasing a shipper's VAR, nothing in this proposal has an effect upon the Code Credit Limits (CCL). Therefore, any shipper deferring a payment would either continue to be within their existing CCL, or would be required to lodge extra security, in accordance with Section V of the UNC. We consider that this would mitigate any additional risk to the GDNs. We also consider that the GDNs will be well placed to manage this risk, which for the reasons set out above would in any case be marginal.

Whilst there may be no immediate impact upon competition arising from this proposal, we consider that this may represent a valuable option for qualifying shippers. In the event that this option is exercised, it may not only free up working capital for relevant shippers, allowing them to grow or otherwise improve their businesses, it could in the extreme prevent them from having to exit the market. We are therefore satisified that despite the qualification criteria being imperfect, the implementation of UNC404 would have a positive impact upon effective competition between gas shippers and gas suppliers.

Objective f) – the promotion of efficiency in the implementation and administration of the Code

Some respondents noted that the GDNs would need to make offline arrangements to monitor the payments received and due; this would potentially be complex and would increase costs. Respondents also noted that no evidence had been presented during the assessment process, or in response to the consultation, to indicate that the benefits of implementation would be sufficient to outweigh the potential costs. Those respondents therefore considered that implementation could be detrimental to promotion of efficiency in the implementation and administration of the Code.

We acknowledge these concerns, but would also note the absence of any evidence as to what these costs may be. As set out above, we do not consider that this modification proposal will impose any significant costs, as GDNs already monitor payments due and subsequently received. We have also noted that the discretion to be flexibile over payment due dates etc, already exists and to the extent that shippers have in the past defaulted on invoice due dates without incurring sanctions, that discretion has been and continues to be used. This is entirely appropriate as whilst GDNs must manage their credit exposure effectively, they should act proportionately and avoid taking actions which may exacerbate the problem. We therefore do not consider that the implementation of this proposal will impose substantial additional administrative costs, but should ensure consistent treatment from GDNs of shippers in these circumstances.

In conclusion, whilst we consider that there may be more effective means of allowing gas transporters discretion in regards to their invoicing, the proposal represents an improvement on the current UNC.

Andrew Burgess
Associate Partner, Transmission and Distribution Policy
Signed on behalf of the Authority and authorised for that purpose.